ScanSoft's Rollup Machine: Consolidation Continues

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In a comprehensive acquisition campaign dubbed Project Tsunami, ScanSoft acquires three companies. In text-to-speech, it purchases Scottish pure-play Rhetorical Systems for $6.9 million. Israel-based automated DA leader Phonetic Systems is the biggest catch, with a $35 million price-tag. Another Israeli-based embedded speech solution, ART (Advanced Recognition Technologies) fetches $21 million. The initial total cash outlay by ScanSoft is only $27.4 million, with the remainder of $63 million total consideration due later, almost all of it in cash.

In what may be the last transaction for a while, ScanSoft appears to have spent most if not all of its remaining cash reserves on an aggressive bet that consolidation will drive revenue growth to the point where it can commit cash from the next two years of operations now. It is a resounding vote of confidence in the prospects for growth by ScanSoft CEO Paul Ricci, as well as major private equity investor Warburg Pincus. The Phonetic Systems and ART transactions are expected to close in January 2005. Rhetorical, the smallest of the three deals, is slated to close in December.

What follows is Opus' initial talking points on the deal, for our clients to use in discussion with management, investors and partners.

Validation of the Conversational Access Paradigm

All three companies have a contribution in terms of 'natural' capabilities: Rhetorical for its natural-sounding TTS, Phonetic for its large-vocabulary search engine which abets deep search (although its mixed initiative program is fledgling), and ART for its handwriting recognition that can be applied in multimodal implementations. Does ScanSoft care about natural language interaction? You bet they do -- check out the recent xHMI initiative, analyzed by Dan Miller this week. ScanSoft's official press release explicitly acknowledged this rationale, referencing "natural, human conversation" as the "predominant means of retrieving information," in the subhead of the release.

Foothold in Markets Where it was Missing

The Warburg connection is important because of its investment in LSSi – directory is a strategic area for ScanSoft's largest private equity investor. As reported by us earlier in the year, Phonetic Systems has been winning business against ScanSoft in the automated DA space despite the latter's clear commitment. The other strategic market, in the embedded space, is wireless handsets. Here, ART and VoiceSignal had been winning versus the legacy L&H embedded solution for handsets. Earlier rumors had a play for VoiceSignal aborted, and ART brings in relationships with TI, Motorola, LG, and Panasonic, among others.

No Confidence Vote in Pure-Play Model

All three can be considered pure-play vendors. Rhetorical was the most exposed, since text-to-speech, its core product, is not a high-ticket, prime automation component, but more of an add-on. As such, it is subject to decisions by a host of influencers, who whether they were a system integrator, ASR vendor, IVR platform vendor or IDE supplier, all probably knew more about TTS than the customer. Pure-plays make sense only where there is a well-understood market and an educated customer. By rolling up a leader in TTS and embedded technology, ScanSoft makes Nuance look smaller, and vindicates IBM's end-to-end portfolio.

Enterprise Customers

The deal brings the leader in high-end automated attendant solutions, Phonetic Systems, together with its closest viable competitor in the space, since ScanSoft acquired Locus Dialog last year. Phonetic's footprint in this is significant, with a strong presence in Fortune 100 accounts for its high-capacity solution. This gives ScanSoft's SpeechWorks unit an entrée into call center opportunities that might have been closed in the past – Phonetic's lack of call center applications is also effectively addressed by this deal.

Compatible Geographies

The three-way deal makes for an interesting geographic study. ART and Phonetic Systems are both Israeli-based companies, so money will be found in consolidating R&D operations back in Israel. While conventional wisdom has arch-rival Nuance receding from Europe, it has done well there in its most recent quarter. What the deal does for Europe is add a strong presence from Rhetorical, adding a second R&D operation in Edinburgh to the existing Belgian lab acquired from L&H.

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Telco Bonus

The deal could arguably be justified purely on the basis of telco relationships: Rhetorical contributes a solid presence within Verizon, as well as Vodafone UK. Phonetic Systems brings recent wins at Qwest, Bell Canada, SNET, and wholesalers Excell and INFONXX. Interestingly, both ScanSoft and Phonetic are reportedly short-listed at Telstra.

Message to Vendors

Consolidation presages expanded product scope. Whether you're marketing recognition engines, TTS software, development environments, packaged applications or any other 'pure' platforms, you can no longer remain a one-product shop. Speech processing's pond is getting smaller while the multi-product fish are getting bigger, through acquisition and diversification. The larger fish will use their heft to widen the channel into the larger sea of opportunities surrounding conversational access to broader sets of information and services.